

# THE STRUCTURE OF A FRANCHISE DISCLOSURE DOCUMENT FOR A NEW FRANCHISE SYSTEM IN MALAYSIA

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## Abstract

Franchising is the fastest growing method of doing business. In Malaysia in particular, franchising has been aggressively promoted by the government since the early 1990s. However, there is little academic research to guide or regulate industry practices. Thus this research investigates the process of developing a new franchise system, with particular reference to the elements of franchise disclosure documents. This research used action research methodology to develop a new practical framework of franchise disclosure documents within the Malaysian government department that handles franchise regulation. Three main action research cycles (with two mini-action cycles for each main cycle) were conducted with three new franchise systems seeking to register with the Registrar of Franchise. To triangulate the findings of the action research, the researcher also presented them at a National Franchise Workshop. These activities showed that the franchise disclosure documents should comprise 25 elements: 9 elements of financial planning and 16 elements of non-financial items. This practical framework for franchise disclosure documents in a new franchise system was adopted by the Registrar of Franchise in Malaysia.

## Introduction

Franchising is the fastest growing method of doing business (Miranda 1995) and has become the most important and popular method of creating new businesses (Justis 1995). Franchises contribute about 10 percent of the world's Gross Domestic Product (GDP) and 14 percent of the world's total retail sales (Mendelsohn 1995; Mendelsohn 1999). Indeed, franchising contributed 49 percent of the United States' total retail sales, and 30 percent of the United Kingdom's and Europe's (Baucus & Baucus 1997; Mendelsohn 1999; Sherman 1995; Swartz 1995).

Many countries have laws affecting this franchising. For example, the United States has pre-contract disclosure documents (Mendelsohn 1999) and France, Spain, Brazil and Mexico have pre-contract disclosure laws. The United Kingdom implemented a Trading Scheme Act in 1996 and Russia has enacted a set of regulation affecting franchising. Italy has recently proposed a bill to regulate franchising (Mendelsohn 1999). Australia has now introduced a Franchising Code of Conduct. In turn, in Malaysia where this research was conducted, the government has promoted the Malaysian's franchise industry aggressively since 1992 (Adzmi

1999) and it has experienced rapid development. The Malaysian Franchise Act 1998 was introduced to protect the franchise industry, and requires registration of every new franchise system.

In general, franchising is an under-researched area that is not well understood and the sector suffers from a lack of reliable information (Dyl 1991; Frazer 1998; Katz & Owen 1992; Welsh 1996). This lack is especially evident in Malaysia (Mohd Ali 1995). The Malaysian Government under the Franchise and Vendor Development Division, Ministry of Entrepreneur Development, Malaysia (Kpun), has offered research grants to conduct research in the franchising area. Some higher education institution and consultants have conducted preliminary studies (Franchise and Vendor Development Division 1999). However, there has been no empirical research about franchise disclosure documents (confirmed through searches of ABI Inform, EBSCO, Emerald, and Kpun databases). A franchise disclosure document is a core part of setting up a franchise because it provides information to a prospective franchisee that he or she needs to make a decision about joining a franchise system. This research about this document will reduce the risk of failure by improving the franchise planning process. Hence, the aim of this research is to develop a conceptual framework for franchise disclosure documents in developing a new franchise system. That is, this paper addresses the problem: *What should be the elements of franchise disclosure documents in a new franchise system within Malaysia?*

This paper has three sections. Firstly, a preliminary framework based on the literature is outlined. Then the methodology of action research is briefly discussed. Finally, a final framework from the action research project is presented.

### **A Preliminary Framework**

A preliminary framework to guide this research was developed from the literature about the process of developing a new franchise system in developed nations and in Malaysia in particular. Entrepreneurs who want to develop and operate a franchise system in Malaysia must obtain approval from the Registrar of Franchise (Malaysia Franchise Act 1998), as noted above. The new franchisor needs to prepare a franchise disclosure document along with other documents (Franchise and Vendor Development Division 1999), for submission with an application form for review by the Registrar of Franchise (Bustaman 1995; Miranda 1995).

This franchise disclosure document for the new franchisee is a part of the business planning process in developing a new franchise system in Malaysia (Franchise and Vendor Development Division 1999; Justis & Judd 1998; Miranda 1995). Information from the business and financial planning is used to develop the franchise disclosure document. We developed a preliminary, very comprehensive list of financial, business planning and non-financial (usually legal and supplement information for more deliberately explanation about the franchise system) elements that could be placed into a franchise disclosure document from various Western and Malaysian sources, as shown in Table 1. The next step was to investigate if those 20 elements were in fact necessary, feasible or desirable in the real world of Malaysia.

## **Methodology**

This research seeks to explore a little-researched area, as noted, that is, the research is necessarily theory-building rather than theory-testing. Thus it was appropriate to use a qualitative methodology to obtain a 'window' on to the complex processes of developing a franchise disclosure document in a new franchise system in Malaysia (Carson et al. 2001). Action research was the qualitative method used, mainly for access reasons. For example, case studies of franchisors, franchisees or consultants could not be obtained because the financial matters in a franchise system in Malaysia are complex and deal with confidential elements. Nevertheless, access to three prospective franchisors and their financial plans was eventually obtained through a group of regulators within the Franchise and Vendor Development Division, Ministry of Entrepreneur Development, Malaysia. That is, the research involved the researcher in participative and collaborative research in the best site in Malaysia to investigate the planning processes of the many would-be franchisors who have to apply for registration with the division.

Action research is practical, participative, collaborative, interpretive and critical in its handling of a research problem (Perry and Zuber-Skerritt 1990). More precisely, in this research, a cyclical process methodology was used that incorporated the process of planning, acting, observing and reflecting on results generated in the workplace to increase the understanding of participants in a workgroup (called the policy workgroup) and others within an organisation (at a National Franchise Workshop towards the end of the research project), and produced a public report of those experience that became the guide for developing a franchise disclosure documents in the government department (based on Altrichter (1990), Altrichter et. al. (2000), Bawden & Zuber-Skerritt (2000), Cherry (1999), Dick (1992), Dick (2000), Kemmis & McTaggart (1988), Kolb (1984), Lewin (1946), O'Leary (2000), Passfield (2000), Perry & Zuber-Skerritt (1992), Rapoport (1970), Revans (1991), and Zuber-Skerritt & Perry (2000)). The action research process for this research consisted of three stages: reconnaissance, two-mini action research cycles for each of the three firms (cases), and a triangulation workshop, as summarised in Figure 1.

**Table 1**

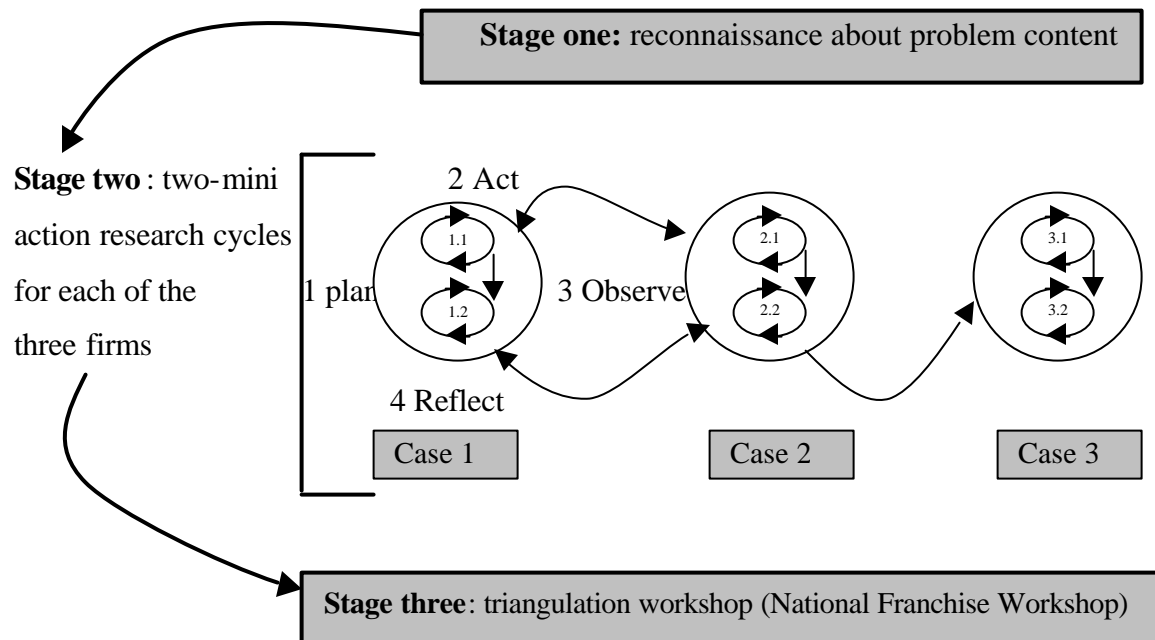
**The elements of disclosure documents possibly needed from a new franchisor to obtain approval to operate a franchise system in Malaysia (f = elements of financial planning; b = elements of business planning; nf = elements of non-financial)**

	<b>Particulars</b>	<b>A</b>	<b>B</b>	<b>C</b>	<b>D</b>	<b>This research</b>
1	Background of the franchisor	✓ b	-	✓ b, nf	✓ b, nf	✓ b, nf
2	Directors/executives' experience	✓ b	-	✓ b, nf	✓ b, nf	✓ b, nf
3	Company's track record	-	-	✓ nf	✓ nf	✓ nf
4	Description of the franchise business	✓ b	-	✓ b, nf	✓ b, nf	✓ b, nf
5	Litigation history of franchisor	-	-	-	✓ nf	✓ nf
6	Franchisor trade mark or service mark	-	-	✓ nf	✓ nf	✓ nf
7	Number of existing franchisees and their success rate	-	-	✓ nf	✓ nf	✓ nf
8	Franchisor select/approve sites	✓ b	-	✓ b, nf	✓ b, nf	✓ b, nf
9	Training and support	-	-	✓ nf	✓ nf	✓ nf
10	Restriction on franchisee's conduct	-	-	✓ nf	✓ nf	✓ nf
11	Level of franchisee's participation	-	-	✓ nf	✓ nf	✓ nf
12	Termination/renewal of agreements	-	-	✓ nf	✓ nf	✓ nf
13	Financial information about pilot	✓ f	✓ f	✓ f	-	✓ f
14	Financial data on the franchisor	✓ f	✓ f	✓ f	-	✓ f
15	Record of bankruptcy or winding up	-	-	-	✓ nf	✓ nf
16	Franchise fee and other fees	✓ f	✓ f	✓ f	✓ f	✓ f
17	Initial investment	✓ f	✓ f	✓ f	✓ f	✓ f
18	Data on help about raising financing	-	-	✓ nf	✓ nf	✓ nf
19	List of franchisor's banker	-	-	✓ nf	-	✓ nf
20	Financial forecast of franchisees' sales	✓ f	✓ f	✓ f	✓ f	✓ f
	<b>Total</b>	<b>9</b>	<b>5</b>	<b>18</b>	<b>17</b>	<b>20</b>

*Legend: A = Scant information about business and financial planning of a new franchise system in Malaysia; B = Elements of financial planning in developing a new franchisee's business in the West; C = Malaysian Franchise Act (1998); D = Bustaman (1995).*

*Note: non financial elements (nf) consist of legal and supplementary information. Business planning elements also include non financial information (b, nf).*

**Figure 1**  
**The procedure of action research project for this research**



Stage one of reconnaissance consisted of:

- ❑ A literature review to increase understanding of the processes.
- ❑ The researcher reviewed the internal and external sources (both documentary and personnel) to ascertain existing knowledge within the Ministry of Entrepreneur Development Malaysia, franchise consulting companies, and other relevant entities.
- ❑ Convergent interviewing was done with ten experts about in the franchise industry in Australia and Malaysia (Carson et al. 2001).

Stage two was two-mini action research cycles with three would-be franchisors applying to register their systems. Six officers were included in this action research project to work with the researcher in what was known as a policy workgroup.

Stage three was a National Franchise Workshop used to triangulate the findings of stage two (Burgess 1984). More than 100 participants attended this workshop. The participants were people directly involved in the franchise industry, such as franchisors, franchisees, bankers, franchise consultants, representatives from Malaysian Franchise Association (MFA), representatives from Ministry of Entrepreneur Development, and representatives from higher education institutions. Thus they represented experienced experts, others thinking of creating or buying franchise business, and the financiers and consultants who resource or advise current and potential franchisees and franchisors. The researcher moderated the workshop and the other members of policy workgroup acted as observers.

## Findings

Findings from this action research project extended the preliminary framework that has been developed based on the literature, to provide two conclusions. To begin, the *findings* of this research added another *four* elements of financial planning to the original five in Table 1. Firstly, a five-year financial forecast of the franchise system must be included because it

allows the franchisee to know more details about the franchise system. Secondly, a forecast break-even analysis for the franchisee's outlet must be disclosed in the franchise disclosure document. Next, the forecast payback period for the franchisee's outlet must be calculated. Finally, the forecast safety margin for the franchisee's outlet must be disclosed. These four additional elements of financial planning in franchise disclosure document had not been considered for a franchise disclosure document before and so are contributions of this research. For the second conclusion, *the findings* of this research added another element to the 15 non-financial elements first considered for a franchise disclosure document. The policy workgroup decided to include the territorial right in the franchise disclosure document because it is also included in other franchise legal documentation.

In summary, 21 elements of the franchise disclosure document (9 elements of financial planning and 16 elements of non-financial) are to be used in the franchise disclosure document when developing a new franchise system in Malaysia. No other research has examined the process of developing a new franchise system as precisely or as broadly as this research, especially in Malaysia where only minimal literatures exist.

### **Conclusion**

There is little research about the process of developing a franchise disclosure document for a new franchise system in Malaysia. In the practical framework developed in this research, the franchise disclosure document is a part of the business planning process needed to prepare by the franchisor for a new franchisee, that is, financial and non-financial information needs to be disclosed by the franchisor in the franchise disclosure document.

This paper not only contributed to the body of knowledge about the elements of franchise disclosure documents in a new franchise system but it also has implications for policy and practice: it produced guidelines for franchise evaluation that were adopted by Registrar of Franchise Malaysia (ROF), and the guidelines could be used to build franchise legislation in other developing countries and even in developed countries like Australia and New Zealand. The guidelines also provide a platform for comprehensive training, and show existing franchise systems how to improve their franchise disclosure document. Moreover, the paper provides another example of the power of the action research methodology. Further research could consider how the findings could be used in other countries, cultures and regulatory contexts.

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